

Keys to Attracting International Business Partners in Russia: Policy Reform and Agribusiness Investment

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EXECUTIVE SUMMARY

Private agribusiness investment at the regional level is increasingly seen as key to achieving public sector goals for economic growth and equity throughout Russia. The Program to Revitalize Agriculture through Regional Investment (PRARI) activity, under the Gore-Chernomyrdin Commission, is designed to facilitate new trade and investment in selected Russian oblasts by responding directly to the needs and suggestions of leading American companies and their potential Russian partners. The PRARI process is intended to help regional officials promote private investment as a source of capital, technology, management and marketing know-how. The purpose of this short paper is to summarize, from the foreign investor's perspective, some of the principal opportunities and impediments to agribusiness ventures in Russia's PRARI oblasts.

The objective of this document was to develop an analytical framework for some of the most significant impediments to the growth of Russian agribusiness. Issues have been grouped into two major categories that have been most often cited by government officials and Russian and international investors as barriers to investment and growth:

- ! Credit and Financial Policy Issues - including monetary and fiscal policy, tax policy, accounting standards, and regulations regarding property affecting its use as collateral;
- ! Rule of Law/Open Markets Issues - including contract and commercial law and regulations governing investment, licensing, trade, intellectual property, etc. and market infrastructure, information and the regulatory environment.

The document seeks to promote dialogue and to improve mutual understanding among regional officials and investors of the keys to making investment attractive, risks manageable and public sector objectives attainable. The paper discusses both opportunities and constraints for accelerated investment in agriculture and suggests that a key to making this process work will be to improve the quality of dialogue between private businesses and policymakers.

The paper seeks to establish a framework for discussion that will assist policymakers and investors to identify mutual priorities, identify the best possible partners, and to create conditions that will promote attainment of economic objectives at the local level.

INTRODUCTION

1.1 Introduction and Background

Russia's economy has changed substantially since the beginning of Perestroika and the events of 1991. Viewed from a historical perspective, many aspects of the change that the Russian economy has undergone in the last 5-7 years are challenging as anything that the country and its people have experienced before.

The reform experience in the 1990's has underlined that the shift from a highly centralized planned economy to a modernizing market-oriented system requires *much* more than the transfer of ownership rights on a large number of state-owned enterprises and collective farms to private shareholders. It has become increasingly apparent that mobilizing private business to provide the investment capital, technology, management and marketing know-how to support pursuit of public growth and equity objectives, while replacing public sector planning, budgets and subsidies, is a long term and difficult process. Nonetheless, many regional administrations already have scored important successes, both in creating an environment that is more hospitable to local and foreign investment, and in attracting specific investments.¹

In early 1997, the Gore-Chernomyrdin Commission's Agribusiness Committee launched a regionally-focused initiative--the Program to Revitalize Agriculture through Regional Investment (PRARI)-- that is aimed at promoting agribusiness investment in progressive oblasts. The aim of this initiative is to promote dialogue and progressive reforms that will accelerate the pace of investment in agriculture, thereby contributing to economic growth and political stability.

This discussion paper is intended to provide Russian regional officials and others with an analytical framework for discussion of how to attract agribusiness. The paper discusses how international agribusiness investment decisions are made and how different elements of policy have an impact on the willingness of international agribusiness to partner with Russian business and government in support of economic growth. Examples drawn from experience in a variety of oblasts are presented.

This paper relies on information collected from a variety of sources. A Conference on Targeting Agribusiness Investment Opportunities in Russia was held in Chicago in July of 1997, in which representatives of some of America's largest agribusiness concerns commented on opportunities and constraints to Russian business ventures. This was followed by telephone interviews with a number

¹ Within the Russian Federation, regional administrative divisions include *oblasts*, autonomous republics and *krais*. The administrative and institutional differences of governing structures among these are not so significant as to merit discussion in the document. The authors take the liberty of referring to all three types as regions.

of the U.S. company representatives, and a meeting of the Agribusiness Committee of the GCC-IX held in September of 1997 in which the PRARI initiative was discussed. During October and November 1997 fieldwork was carried out by joint Russian-American teams in order to obtain in-depth information from oblast-level officials and Russian and foreign agribusiness investors. The information-gathering missions focused on four specific oblasts (Samara, Saratov, Omsk, Vologda) and Kuban Kray, or as it is often known, Krasnodar.

In preparation for a January 1998 workshop to be held in Samara, the authors prepared a *Checklist for Attracting Agribusiness Investment* included in Appendix 1. That document is directed at helping participants to: 1) better communicate with agribusiness regarding investment opportunities and how to work together for mutual benefit; and 2) set reform priorities that will have the greatest potential impact in encouraging investment.

The discussion below draws on the actual experiences of investors in a number of different Russian regions to address (a) questions that international business asks when making investment choices, and (b) how policies affect business investment decisions

In order to facilitate reflection and discussion, a variety of policy issues have been grouped under two major categories, often cited by government officials and Russian and international investors as being the source of barriers to investment and growth:

- ! *Credit and Financial Policy Issues* - including monetary and fiscal policy, tax policy, accounting standards, and regulations regarding property affecting its use as collateral;
- ! *Rule of Law/Open Markets Issues* - including contract and commercial law and regulations governing investment, licensing, trade, intellectual property, etc. and market infrastructure, information and the regulatory environment.

1.2 Opportunities and Challenges to Agribusiness Investment

Encouraged by the Gore-Chernomyrdin Commission process and other developments in the Russian policy and market environment, major U.S. and multinational agribusiness are taking steps to invest throughout Russia. For example, six major U.S. and multinational agribusiness companies interviewed as part of field work for this assignment have recently announced plans to make \$80-100 million in new investments in Krasnodar and Omsk over the next six to nine months, and have begun planning for even more substantial expansion over the next several years.

- ! *The General Director of one Krasnodar company reports that government officials have been extremely supportive in facilitating their initial \$80 million investment and rehabilitation project begun after the purchase of a processing facility that was being privatized. This supportive policy posture has been one important factor in the decision*

to invest another \$40 million in expanding the original investment.

- ! *U.S. and European firms are expanding their investments in the western Siberian area, with the Omsk being a central staging area for a number of these firms. These investors have noted the excellent support which the regional Duma (Parliament) and Administration officials have provided in ensuring the official licensing and approval of these investment plans.*

At the same time, there are currently barriers that threaten to block the new investment in a number of oblasts. For example:

- ! *One major U.S. food and agribusiness company recently announced that it plans to leave Russia because of difficulties it encountered in achieving annual profitability targets in spite of the fact that it holds a contract which guarantees the purchase of its production output by a major restaurant chain.*
- ! *Another agribusiness indicated that a specific oblast policy decision aimed at improving debt repayment by restricting grain shipments from the oblast, however well intentioned, interfered with market operations, jeopardizing both its ability to meet contracts and local farmers' ability to generate the revenue needed to repay debts and feed their families.*
- ! *A major U.S. farm machinery company reported that increased tariff and tax rates on imported machinery during this past year have discouraged recent initiatives to expand leasing services in several regions.*

If the overall picture is mixed, evidence from even the most conservative oblasts indicates that the shift toward a more market oriented economy is solidly underway. Since the federal government has made progress in stabilizing the economy over the last two years, oblast officials and companies managers alike are beginning to find that they can once again focus their own efforts on the implementation of growth-oriented strategies that go beyond the short term.

The spirit of cautious optimism voiced by some of those participating in the new process— among commercial agribusiness managers, financial intermediaries, and government officials—may ultimately serve as the basis for increased dialogue and the emergence of common vision of a constructive economic environment.

Discussions with government officials and business representatives in the course of the field work for this assignment, and previous activities, have provided insights into problems that often arise when decisions are made in the absence of constructive dialogue. Examples were identified where representatives of government and the business community appear to be seeking similar and compatible objectives, but fail to effectively communicate those objectives to one another. *Improved communication is key to successful attraction of private capital, technology, management and*

marketing know-how to help achieve public goals for economic growth and improved incomes.

In discussion with government officials at the oblast or kray level, the point is generally argued that access to financial resources, especially credit, is the primary constraint to gaining a major increase in agricultural and agribusiness investment. When talking to business representatives, however, issues related to rule of law and open markets, (including contract enforcement, regulatory requirements and ownership rights), are often cited as the biggest impediments to investment. Results of our analysis indicate that while there is some truth to both groups' concerns, outcomes are sometimes confused with their causes. For example, lack of investment may not be solely the result of lack of available credit, but also a result of lack of collateral that can be used by newer farmers and agribusiness entrepreneurs to get business moving. Since privatization, lack of collateral is often an issue of restrictions on or inability to use land as collateral because oblast land laws may not be consistent with federal rules.

In evaluating the environment for business, investors pay close attention to government policies and how they raise or lower barriers to success. These policy considerations include, for example, the general attitude of government toward foreign investment; investment and ownership restrictions; the taxation system and incentives; currency and exchange controls; legal mechanisms for the protection of intellectual property (i.e. copyright and trademarks); regional incentives and priority sector incentives. Each of these factors will be considered not only in light of its formal character—the language of laws and regulations—but also in light of their application:

Are rules enforced uniformly throughout the economy or are they applied selectively, protecting or promoting certain enterprises while raising barriers for others?

Do government authorities encourage dialogue with stakeholders in the economy or do they make decisions in a precipitous manner?

Do policymakers view private business as a productive partner in economic development or as an annex to their own institutional authority?

The following sections of this document highlight some of the major policy issues of special interest to investors and public officials and provides examples of some of the ways that individual oblasts and businesses have solved problems to work together to contribute to economic growth through investment.

CREDIT, FINANCIAL AND INVESTMENT POLICY ISSUES

2.1 Monetary & Fiscal Policy, Inflation, Credit and Exchange Rates

Problems: Most of agriculture is still dependent on subsidized credit from the Russian Federation. Interest rates on seasonal farm credit are about 13 percent, while the Central Bank's prime rate is 28 percent. The positive national trend in lowering inflation rates should lead to greater levels of finance from private capital sources becoming available to the agricultural sector and a decreasing requirement to allocate scarce state funds for subsidized credit schemes.

If progress continues on keeping inflation in check, interest rates are likely to fall, and the need and justification for subsidized agricultural credit will be reduced. Until substantial amounts of commercial credit is available for both production agriculture and agribusiness, availability of credit will continue to pose a central constraint to investment in the sector.

Recent developments on international financial markets are having an impact in Russia as well. Federal policy to provide subsidized credit to agriculture at one fourth of the Central Bank rate means that commercial sources are not likely to be interested in the sector. At the same time, the capital requirements of agriculture and agribusiness far exceed the available soft loan funds. For example, the annual working capital requirements of Krasnodar agriculture for 1998 are estimated at about 5 trillion Rubles, while the total soft loan fund available for the entire Russian Federation for 1998 is expected to be at most 7-10 trillion Rubles.

Solutions: There are a number of exciting developments in commercial credit for agriculture and agribusiness. SBS Agro, which in 1997 was responsible for providing 95 percent of the subsidized federal crop credit, is expanding its network of branches throughout the agricultural regions of the Federation, and developing a variety of new financial products and services that should make credit more widely available. At the same time bank officials report that credit recipients are being screened more carefully and that outstanding loan balances and nonrecoverable loans are down substantially. SBS Agro also intends to provide a variety of business planning and support services aimed at improving the success rate of borrowers and increasing the likelihood that the business will succeed and be able to repay loans. For 1998, twelve banks have been approved to provide federal soft loan credits.

In the Omsk region, SBS Agro is currently cooperating with several European commercial banks from Germany and the Netherlands related to agricultural processing equipment. It is collaborating with the European Bank for Reconstruction and Development (EBRD) which provides financing for loans to small businesses and has been the local banking partner for the US Export Import Bank for establishing the Case farm machinery program. SBS Agro has branches in each of the 32 territorial divisions of Omsk oblast, and has targeted this year's state supplied agriculture credit portfolio of 230 billion rubles across different farm types, in addition to an increasing number of agribusiness firms.

SBS Agro is fully supporting the new Case Corporation's machinery station program for which machinery will arrive beginning in early 1998. Despite a relatively well developed banking sector in the oblast, which includes 18 resident banks and 50 branch banks, with the exception of SBS Agro, few agribusiness enterprises are currently receiving bank credits. The two most important developments required for significant increases of private capital and credit to the sector must include a continued lowering of real positive interest rates and increasing productivity and investment competitiveness within the agricultural sector.

2.2 Taxation

Problems: There are a multitude of federal and oblast level taxes applied to agribusiness enterprises. A review of the current system identified 12 different federal taxes and a similar number of local oblast and kray taxes that can be imposed. Oblast and kray officials indicate that they are pleased to provide exemptions from local taxes to help new businesses get started, but with uneven application of taxes in the first place and low tax collection rates, this is often of limited value in giving new businesses a competitive jump start. With an official federal tax burden that is substantially higher than that which is in place at the oblast level, an integrated approach to looking at taxes is important.

For a number of enterprises, tax collection levels are apparently extremely low, so that the benefits of a short term tax abatement for a new investor are less important than the competitive disadvantage of law abiding companies which must compete with those who avoid paying taxes or obeying other rules. Wine and spirits production was singled out for special mention. The shadow economy has reportedly been growing substantially across the board. Since U.S. investors tend to pay their taxes, failure to apply tax policy equitably will be viewed as a disadvantage by those who want to be long term partners in Russian agribusiness development. A level playing field is one key to attracting the kind of international investors Russia wants and needs most.

While tax collection rates throughout Russia are reported anywhere from 40-60 percent, Omsk officials reported much higher rates of collecting regional taxes. One example presented was with respect to the collection of land taxes. At the same time representatives of different farm types and enterprises emphasized the multitude of tax liabilities as a major disincentive to higher rates of investment and described evidence of considerable energy invested in minimizing and avoiding certain taxes. While Oblast officials have provided some flexibility with respect to agribusiness investors, short-term benefits may be off-set in the longer term by uncertainty and increased risk which could be the perception of potential investors.

Solutions: Farm and agribusiness owners/managers provided consistent and straightforward recommendations. These would appear to be logical and provide potential investors greater

incentives and predictability for their investment decisions.

Simplifying the tax structure by consolidating numerous taxes into a few well-understood tax requirements which are predictable and provide an equitable sharing of the tax burden was recommended by everyone. These informants felt strongly that tax collection rates would actually increase with a simplified system with realistic tax burdens given the status of restructuring of the agricultural sector.

Problems: Federal tariff structure for imported capital goods and equipment for both production agriculture and agribusiness processing equipment were highlighted as worsening the investment environment in the agribusiness sector. Companies negotiating such investment for the region were discouraged by federal actions during this past year which increased these tariffs. One source mentioned that this development had put an end to a current negotiation involving a U.S. machinery manufacturer.

Solutions: With Russia negotiating to enter the World Trade Organization, Russian businesses will increasingly face international competition, making access to productivity enhancing technology and equipment critical. Trade policy is generally a federal issue, and requires balancing foreign exchange requirements to pay for imports with the need for capital equipment to increase productivity and international competitiveness, ultimately saving or generating foreign exchange. It will be crucial that oblast and federal implementation of WTO accords be harmonized.

2.3 Property from the perspective of collateral: land, capital equipment and commodities

Problems: The Duma of Saratov oblast recently passed legislation that allows for the sale of land, and thus the use of land for collateral. In oblasts with more restrictive land ownership, even with land that can be leased or used in perpetuity, financial institutions have not generally been willing to provide credit. Capital equipment can be used as collateral, but new businesses, especially emerging Russian entrepreneurial agriculture related businesses, such as new private farms, are less likely to have such collateral. Even though bankers report that their repayment rates tend to be very high, they will not lend without collateral, so that land law which does not include ownership rights, rather than protecting land users as intended, actually makes it impossible for their businesses to obtain the credit that they need.

Solutions: Many in Russia see the issue of land privatization primarily as a tool for land sales and purchases and the source of a potential threat for the alienation of tenure. In fact, in a market economy, private ownership of property is less important for the number of transactions that take place each year than as a means to have an interest which can provide a basis for commercial credit. Many would be surprised to realize that in other countries, like the United States, mortgage backed credits account for about 70 percent of the credit available to agriculture. In Russia, private ownership of land and machinery, and development of collateral schemes whereby commodities can be used as a source of

credit all merit consideration as part of a strategy aimed at increasing the credit made available to the sector from commercial sources. While land and property ownership alone will not ensure the availability of credit, they will provide a basis for offering commercial lenders the security needed in order to make loans.

Borrowers will also need to have solid business plans and a stable business climate in order to ensure that they will be in a position to repay those loans.

2.4 Treatment of foreign investment capital/ repatriation of profits

Problems: Treatment of foreign investment capital and limitations on repatriation of profits were not mentioned as a major issue by those interviewed. Business surveys conducted by Louis Berger International did find that foreign exchange controls have sometimes been a problem. In general, these are policy issues that must be resolved, above all, at the Federal level. However, it is worth pointing out that arbitrary actions at the oblast level—including decrees that restrict marketing activity or which ban commodities exports from the oblast—can serve as a powerful indirect mechanism to effectively restrict the movement of foreign investment capital.

Solutions: Any measures which directly or indirectly restrict the freedom of Russian or foreign investors to liquidate or transfer assets or to obtain access to markets will invariably have a chilling effect on the investment environment. It is of the utmost importance that policymakers undertake consultation with representatives of the business community prior to implementing any decisions that may even indirectly restrict the movement of capital or business proceeds.

2.5 Subsidized credit and inputs

Problems: Since 1991, high rates of inflation and low levels of profitability in the agricultural sector created the need for a subsidized credit program to move any credit into the agricultural sector. SBS Agro has reportedly performed quite well in recent years in allocating such credit to different types of farm enterprises in addition to guaranteeing lending to certain agribusiness firms, including joint ventures such as Case. As with all state subsidized input schemes, there is a severe limit to its reach and administrative costs are high. Since in many cases, repayments are made in kind through another state intermediary, (such as Omskprod, the Regional Food Corporation), the real costs for the subsidized credit program are understated and little understood.

Solutions: Most of the PRARI oblasts have traditionally been regional exporters of agricultural products and clearly can potentially expand their “export orientation” as their agricultural sector positions itself for future growth. To fuel such a growth scenario, private sources of investment capital and operating credit at market prices must be attracted to the sector. This will take place only when the structure and profitability of the sector become increasingly dynamic. Until that time, subsidized credit and input schemes will continue to be an important element of transition strategy.

Clearly the principal strategy for decreasing the importance of subsidies will be derived from increasing the competitiveness of individual enterprises with regard to productivity, quality assurance, managerial efficiency and improved marketing strategies. Oblast administrations should consider establishing consultation units to provide assistance to individual enterprises so that they can develop and implement business plans that focus on those specific objectives. The provision of subsidies could be conditioned upon the development of such business plans and calendars for their implementation.

2.6 Accounting standards

Problems: There are substantial differences in the way traditional state owned enterprises have measured costs and returns and the way that it is done in other parts of the world. For example, farm profitability typically does not consider farm shareholder “wages,” bonuses and payment in kind in farm income or expenses. As a result, profitability calculations are different than they would be perceived elsewhere. Where oblast officials hope to interest foreign investors in purchasing all or some of the assets and obligations of former state owned enterprises, they should be prepared to discuss these factors in terms that international investors will understand.

Solutions: New accounting standards are scheduled to go into effect throughout Russia. Although the PRARI teams did not have an opportunity to examine the new legislation, they note that there is substantial local expertise available within Russia to assist with translation of traditional accounts into a format that Russian entrepreneurs and international business will require. Unfortunately, such expertise is not universally available in all oblasts. This indicates the transition to new accounting methods and standards will likely require the provision of training in new methods to professionals in the oblasts. Such training programs will require the substantive support of local administrations and businesses alike.

2.7 Inter-oblast policies affecting credit and financial flows

Problems: Moscow remains the critical center for many business and financial decisions, even at the oblast level. For example, SBS Agro, which has been responsible for subsidized agricultural credit, has the advantage of many branch offices around the federation, and plans for many more. Nonetheless, many decisions will still require approval from Moscow.

Solutions: For the foreseeable future, Moscow is like to continue to occupy a central role for influencing or determining financial and business decisions that extend to the regional level. The management of key macro-economic indicators (inflation and exchange rates, etc.) will continue to heavily influence investment decisions at regional levels. Linkages to national policy will affect the pace of agricultural reorganization and increased profitability within the sector; this will, in turn, strongly influence the attraction of private capital and credit into the sector. The pace of these developments should also determine the timing for phasing down the subsidized credit and input requirements.

In Omsk, for example, the traditional role as a regional leader and major exporter of agricultural products has already been a factor in attracting new investment. For example, the Case farm machinery investment is based on a strategy with objectives that see the oblast as a starting point for additional areas of western Siberia as well as Central Asia. The Hoechst and Ciba-Geigy investments have similar geographic strategies which are logical for any larger scale agribusiness investor coming into the region. This makes coordination of policies among oblasts, as well as between regional and federal policies, important considerations in the cost of doing business.

2.8 Permitted share of foreign ownership of investments

Problems: In discussions with oblast officials about the amount of foreign capital investment they seek for local investments, the target of 35 percent ownership was often suggested. Many oblast officials appear to have difficulty understanding that the *underlying goal of investors is to ensure that they do not take unnecessary risks, and that the venture in which they are involved has the best possible chance of success.*

Solutions: A controlling ownership is often the simplest way to ensure that the enterprise focuses on the objective of risk management and profitability, but it is not the only way. An investor who is satisfied with the management and performance of an enterprise might consider a minority ownership share if there are other safeguards to his or her investment, and there are advantages to a minority share in terms of contributions made by other partners.

In many cases, however, those who must provide technology, management expertise and marketing know-how along with capital are likely to feel that a greater than 50 percent interest will be necessary in order to provide them with sufficient control to ensure that the investment can perform. In discussions of this topic, it is important for local officials to indicate that they understand the validity and mutual interest in meeting the performance goal. This can be a starting point for structuring discussions of ownership arrangements.

Regional officials who understand and are able to clearly communicate their goals and needs and what they have to offer will be in the best position to engage potential investors in conversations regarding the way that an enterprise involving private investment will ultimately be structured. Openness to a variety of options at the outset, coupled with a clear assessment of what each party has to offer, is likely to help regional officials identify the best potential investors, and to develop a partnership that is mutually beneficial.

RULE OF LAW/OPEN MARKETS

3.1 Definition

As a centrally planned economy becomes more open to market forces, a variety of new requirements develop in order to ensure that markets operate efficiently and effectively, and can continue to do so regardless of short term shifts in individual political or regulatory authorities or their responsibilities.

The terms “rule of law” and “open markets” are often used to define a range of policy issues, (including contract and commercial law and regulations governing investment, licensing, trade, intellectual property, etc. and market infrastructure, information, and the regulatory environment) all of which depend upon the existence of an operating environment that is based on law and in which rules are enforced with impartiality.

3.2 Political Stability / Risk Management

Problems: Investment decisions in agribusiness can best be understood as a question of risks and rewards. Investors will be more willing to invest for the longer term if they are confident that the risks of doing so are low. Likewise, the return required to make a decision to invest will be more moderate, if the risks are lower, and the investment is considered sufficiently secure to permit the investment to be recovered over a number of years.

Indicators of political stability cover a wide range of factors, ranging from civil security, law and order, the consistent application of laws and regulations, and the ability of investors to plan for the future with some modicum of success. Political stability issues at the federal, oblast or kray and municipal levels are all important to investors in terms of the risks they perceive and the level of return required to attract them in light of that risk. Regional officials perceive this issue from several perspectives:

- ! *In one case cited, an international input supplier reported that with a change in Governors, regional officials refused to honor guarantees provided by the previous administration, resulting in a \$6 million loss to the supplier;*
- ! *In another case, oblast officials blamed uncertainties and developments at the federal level for a decision by the EBRD not to go through with a planned \$1 billion program.*

Solutions: Local government officials are especially sensitive to the impacts of events that take place outside the oblast on their ability to attract investment, however they often underestimate their own ability to generate conditions that can create greater economic equilibrium in the areas under their authority. Policy decisions at the oblast level can often go far toward creating a sense of security on the part of investors, and the existence of opportunities for regular dialogue will go far toward

reducing investors' concerns about the predictability of the operating environment for business within an oblast. In their discussions with prospective or existing investors it is essential that oblast officials be willing to discuss political stability issues and promote dialogue on these issues within the business community.

For example, Oblast officials in Omsk point to their solid record of stability in the region strengthened by their attention to being up-to-date in the payment of pensions and debt, two indicators which have caused turmoil in other regions of Russia. They also highlight strong support from a "development-oriented" Governor and solid working relationships between the Duma (in particular, the Agrarian Committee), the region's administration, as well as the business community. They highlight the fact that over 300 business joint ventures are currently underway within Omsk, although as yet only a handful of these are agribusiness enterprises.

3.3 Contract and Commercial Law/ Arbitration and Dispute Settlement

Problems: Ensuring contract enforcement and debt collection are both considered major costs of doing business. When oblast authorities speak with investors, it is important to recognize that many will think of investments as a way to serve markets not only in the oblast, but also in other parts of Russia and international markets. Thus, even where contract enforcement, debt collection or organized crime may be relatively well controlled within the region, investors will have concerns about dealing with these issues in their target markets, such as Moscow, and in the ports where imported equipment and selected raw materials as well as exported finished products may pass.

Although oblast officials are often quick to point out problems raised by unscrupulous businessmen, arbitrary policy decisions can also erode investor confidence very severely. One example cited above was imposition of a regional export ban intended to keep those who had received credit from selling products outside the region before they had reimbursed outstanding production credit from the regional government. *While this may have facilitated debt collection for some farms, it had the unintended consequence of preventing all producers and traders from taking advantage of high prices associated with an early grain harvest.* By the time the export ban was revoked, other oblasts had begun harvesting, and prices had begun to fall. The cost to producers in terms of reduced revenue may have offset a substantial part of the benefit of providing them with subsidized credit in the first place.

While the intent of the export ban policy was to prevent only those with outstanding debts from selling and shipping products to other oblasts, many producers sell to trading companies, who in turn sell to customers elsewhere in Russia. One impact of the ban was that these traders were unable to get the grain to meet contractual arrangements that they had made in order to be able to pay higher prices to farmers at harvest. Another impact was that a glut of grain that could not leave the region depressed prices, so that farmers had less income with which to repay debts. Furthermore, since credit from local and foreign input suppliers is one way that limited availability of credits is overcome, the ban undermined the ability of these groups to obtain reimbursement, limiting their ability and willingness

to extend future credits.

Whatever its rationale may be, arbitrary policy-making that constrains market access will always serve to deter investors and reduce their confidence in the operating environment.

Where contract enforcement through the legal system is not reliable, other methods are often used to ensure that credit is repaid. For example, a number of Russian businesses interviewed indicated that they have recourse to informal “strong arm” collection methods to ensure that debts are repaid. This puts international investors who will not use such tactics at a disadvantage and lower their confidence in the authority and effectiveness of government officials who are charged with maintaining law and order.

Solutions: Local officials should be in a position to speak frankly with potential investors about these issues and how they can be addressed. *Once again, the important thing to remember is that perceived risks influence returns required to attract an investment. At the same time, denial of the existence of risks that are widely known to exist will be counterproductive, reducing the confidence of investors.* Foreign investors in Russia recognize that the country is moving through a period of transitional uncertainty. While they do not expect government officials to be able to solve all of their problems, their confidence in government will be enhanced by frank dialogue and the willingness to discuss the real problems that they are encountering. A reliable system of contract enforcement with recourse through the legal system is a key focus of prospective investor concerns and will always be given high priority in the evaluation of sites for prospective investment.

3.4 Regulatory/ Licensing Requirements, Enforcement and Transparency

Problems: A number of successful international investors have often developed informal methods for using people with political influence to obtain permits and to meet or obtain exemption from regulatory requirements. In some locations, it is perceived that political relationships rather than adherence to the stated rules are the secret to success. Major differences are perceived in how this works in different oblasts, and in different municipalities and districts within oblasts or krays. Investors report some cases of a single official being extremely helpful in assisting them through a confusing maze of regulations and different organizations. They all report cases of a single official blocking a major project for what they perceive to be a small issue.

Solutions: Oblast administrations that are seriously interested in attracting and retaining top quality international partners should be prepared to consider ways to facilitate with bureaucratic and administrative processes and regulations.

Having a single office responsible for coordinating “problem solving” for business was mentioned as a desirable goal by a number of those interviewed. Regional officials might consider the possibility of a single office with responsibilities for attracting business investment that will meet

economic development goals, provide the administrative information and assistance needed to attract investors, and solve problems so that they stay and grow as good citizens of the region. Investment promotion offices are quite successful throughout the world and can be an important asset for Russian oblasts as well. Investors always respond positively to administrations that can demonstrate a strong commitment to providing the kinds of services that are required to establish a new investment project and they are generally prepared to pay for such services if, in fact, the services are of reliable value.

3.5 Open Market Linkages at the Federal-Oblast Level

Problems: A key element in successful economic development is the linkage between federal and regional policy decisions. For example, import duties associated with trade with Ukraine were recently reduced sharply by the federal government. While open trade is likely to be beneficial to all parties over the long term, it can have unexpected short-term consequences for the competitiveness of production at the oblast level.

Solutions: Improved consultation between the federal and regional governments and producers can help to minimize the unintended short term problems. For example, an oblast may promote production of a crop or product that could be rendered non-competitive in the short run by a federal policy decision. The risk of such an occurrence means that private investors will want to be assured that an operation in which they might invest can be competitive, even in the absence of protective trade barriers. Alternatively, they will expect higher short term returns to offset the potential risk.

In a planned economy, operators of different enterprises are often expected to work together to contribute to a common plan. Collusion is expected to permit the enterprises as a group to agree on a common position with government in setting targets and competition. However, in a market oriented economy, the forces of competition among enterprises are intended to ensure that individual operations are as efficient as possible, and that consumers benefit through the lower prices that result. In such a case, there is a need for some cooperation among competitors to help influence some government policies. At the same time, it is important that cooperation among enterprises not reach the point of collusion that prevents consumers from getting the benefits of competition. In many market economies, this has led to the development of a body of anti-trust laws, called “competition policy” in the European Union. This is one of a number of areas where government needs to develop a policy and play a new regulatory role.

3.6 Land use planning and zoning

Problems: Conversion of agricultural land to other uses is a concern in Krasnodar and other regions. While such transfers are officially prohibited, this is one area where political relationships are reported to play an important role in obtaining exceptions to policy.

Solutions: A number of countries around the world have determined market-oriented ways to keep productive land in agriculture when rising values make that land attractive for other uses or when local government falls under pressure to maximize tax revenue. This is an issue that oblast officials can expect to face over time as they succeed in encouraging economic growth.

The development of land use zoning procedures and transparent processes for resolving land use issues must become a medium-term priority at the local or municipal level, especially in areas that are under growing population pressure or where natural resources are threatened by industrialization. The formulation of land-use based tax schedules, processes that require public hearings or consultation for the granting of land use variances, and public reporting of administrative decisions that grant exemptions are key elements of any eventual strategy that may be developed.

3.7 Intellectual property issues

Problems: Intellectual property protection (i.e. legal recognition of ownership of patented or licensed technologies, products, processes and trademarks) is a major issue in ensuring that investors provide Russia with state of the art technology. As long as such protection is questionable, investors will hesitate to make available those technologies, products and processes that can make the greatest contribution to local economic development.

For example, agricultural chemical companies and input suppliers have substantial interest in the Russian market. Monsanto is working on a pilot project aimed at testing no-till cultivation on 20,000 hectares of land in Krasnodar and in other regions as well. The technology has the potential to offer substantial benefits to the region and federation in reducing costs and increasing productivity. Yet, in this and many other projects, there are several levels of technology with which this technology can be introduced. The most highly productive will involve provision of bioengineered seeds that will only be made available if the investment in their development can be protected from pirating.

Solutions: Like other aspects of the rule of law, intellectual property protection can exist only in an environment where judicial recourse is nondiscriminatory, governed consistently by the language of the law and supported by those who are responsible for law enforcement.

The extremely high level of education of Russian technicians and the country's history of technological innovation make it imperative that intellectual property protections be recognized and enforced, both to protect local innovations and to attract state-of-the-art technologies to Russian agribusiness. There

can be little doubt that Russia can continue to be a source of innovation, however it will not be able to maximize the profit from its own technologies if it is unable to provide legal protections without discrimination.

3.8 Migration/Labor laws

Problems: Ensuring that agribusiness investment high-quality employment and economic growth is generally an important goal for local officials.

Nonetheless, many regional officials are preoccupied with the social objectives of employment, often even at the expense of the viability of individual enterprises. They are also sometimes driven by the fear that the recruitment of expatriate labor will take place at the loss of Russian jobs.

Pressure placed upon investors to assume an overly large workforce for social reasons often result in pressures to look elsewhere to invest, or start a new enterprise instead of investing in viable existing enterprises.

Solutions: Potential investors looking at existing enterprises will analyze the size and quality of the labor force and distinguish between enterprise requirements and employment that is driven principally by social objectives. They will examine options for restructuring to ensure that the enterprise can be sufficiently competitive to succeed. Likewise, many local officials recognize that if requirements for retaining unproductive members of the labor force are too onerous, the investment will not be made, and all of the jobs will be lost.

Investors interviewed in Krasnodar provided an example of their own positive experience in investing in a privatized state owned enterprise, and developing a work force that can be productive with modern equipment. They described an employment strategy that allowed for reductions in force through attrition over time and investments in training the existing labor force to improve its productivity. They predicted that as a result of business growth, they anticipated an eventual need for more workers than had been employed at the failing state enterprise that they had acquired.

Concerns among oblast official who seek to place limits on expatriate labor have proven, by and large, to be unwarranted. Costs of maintaining expatriate employees in Russia are high, and there are many highly skilled Russian workers available. As a result it is the norm for companies to shift management and technical responsibilities to Russian nationals at the earliest possible time.

One top priority for the Russian government is to look at management of former State Owned Enterprises that are now joint stock companies. In many cases, while the ownership structure has changed, the management structure and approach have not. One key to successful harnessing of agribusiness investment for economic growth will be to ensure that joint stock companies can benefit from not only the capital and technology that can be obtained through international investment, but also the management and marketing know how required to ensure that those enterprises can compete.

Interviews indicated that many managers are more interested in capital and technology alone because they fear for their jobs, or like arrangements that they currently have. One major challenge for oblast officials is to determine how to motivate current managers of joint stock companies to take up the challenge of managing in a competitive environment.

ESTABLISHING CONSTRUCTIVE PROCESSES FOR REFORM

4.1 Establishing Common Policy Objectives

One outcome of the rapid changes that have taken place in Russia in recent years is that the policy agenda at all levels of government is increasingly crowded. At the national and oblast levels, public officials are overwhelmed by the need to adjust to rapidly changing circumstances, to forestall the economic decline of key enterprises and entire communities and to adjust to the evolution of a political and economic culture in which subsidies are no longer a viable instrument of public administration. Issues emerge daily that make urgent demands on the attention of policymakers, placing all issues simultaneously at the forefront of administrative consideration.

The difficulties of establishing mid- and long-term policy objectives in such an environment are overwhelming, often leading officials to abandon any prospect of dialogue as they focus on the latest, most immediate crisis situation. The unfortunate outcome of this situation is often precipitous decision-making that leads to unforeseen and negative outcomes for even the intended beneficiaries of a particular policy decision.

In these circumstances, individual oblast administrations need, more than ever, the support of the business community, particularly in efforts to formulate priorities for policy reform and strategies for their implementation.

The potential contribution that structured public-private sector dialogue can make to the policymaking process cannot be underestimated: *by taking into consideration the views of business groups, policymakers are able to identify initiatives that will enjoy widespread support and which can contribute to the achievement of long-term policy goals.* By engaging in serious dialogue with representatives of the business community, political leaders often discover that they are able to reduce the degree of cynicism and distrust that is often endemic. If they are successful in mobilizing this constituency, government officials and policymakers find that they are able to broaden support for their own views and more reliably implement long-term strategies for economic development.

Even on those occasions when the views of policymakers and businesses differ, the existence of a dialogue in which public officials can explain their rationale often enhances the likelihood of compliance with laws, regulations, standards and controls. By soliciting the views of those who hold a stake in economic decisions, policymakers often find that compromise is not only possible, but that it can be utilized as leverage for achieving longer term economic objectives.

A second benefit of such dialogue is that it provides a complement of resources and technical information for those who must monitor and evaluate the impact of economic policies, providing clear and immediate warning when policy outcomes are different than those which were anticipated.

Timely awareness of emerging economic or political distortions thus enables officials to adjust policies accordingly, minimizing negative outcomes.

Interviews with foreign and Russian businessmen and oblast officials have indicated that there is not a widespread divergence of views on many of the key policy issues that are raised in this document. Differences of opinion tend to focus, instead, on the prioritization of policy issues, appropriate strategies and timetables for their implementation, and the attribution of responsibility for implementing policy reforms. Oblast officials often believe, mistakenly, that their ability to effect reform is diminished in proportion to the decline in the fiscal resources at their command and generally fail to recognize the degree to which private business is willing to assume certain responsibility for some of burdensome social prerogatives that were formerly the responsibility of the socially-based collective enterprises. Even when they recognize the ability of the private sector to assume a greater role in the economy, officials are often fearful of losing power and prestige. At the same time, businessmen often attribute inordinate responsibility to the oblast administrations to resolve problems that are well within the domain of private business.

4.2 Mechanisms for Promoting Policy Dialogue

Among the mechanisms to promote dialogue between policymakers and private business that have been established in a wide variety of national and local settings are the following:

Private Business Initiatives

- *Establishment of business associations*
- *Convening issues-based policy workshops and debates*
- *Submission of position papers to policymakers*
- *Drafting action agendas for policy action*
- *Establishing policy impact monitoring groups*

Public Sector Initiatives

- *Convening public hearings on proposed legislation and decrees*
- *Soliciting position papers on key issues from representatives of the business community*
- *Circulating proposed legislation and decrees for public comment*
- *Soliciting planning inputs on appropriate strategies for policy implementation*
- *Establishing policy evaluation and monitoring units to assess and report on the impact of policy implementation*

4.3 Strategic Considerations in Policy Reform

The Samara conference provides an opportunity for representatives of the federal and oblast governments to reflect on a variety of approaches to achieving the benefits increased investment in agribusiness and on the ways in which investment can correspond with larger economic policy objectives. While the economic and political circumstances of individual oblasts vary widely, the policy concerns of officials and private businessmen are likely converge on a variety of common issues that have already been identified in the conference documentation. Developing a clear vision of policy objectives and identifying the variety of strategies that may exist for overcoming policy dilemmas should be matters of the highest priority.

A key consideration in all discussions of the reform agenda must be *strategies for policy implementation*. In many cases well-intended reforms have failed either because decision-makers failed to define their policy objectives adequately, or because they were overly optimistic about the capacity of government institutions to adapt to change. In that light, a number of questions that must be taken into consideration in considering policy reform activity are the following:

Who are likely to be the principal beneficiaries of reform and how can their support be mobilized?

Who is likely to lose power, privilege or advantage in the marketplace as a result of reform? What measures can be taken to minimize their cost over time?

What is an appropriate timetable for reform? How much time is necessary for a transition from the status quo?

What institutional changes will be necessary to implement the reform? What kind of training or information will be necessary so that officials can perform their responsibilities once the reform is in place?

What information must be made available to educate the public so that they can adhere to any new rules or regulations or so that they can capture the intended benefits of reform?

Are measures in place that will allow policymakers to monitor and evaluate the impacts of reform, or that will allow them to make necessary changes if reform outcomes are other than those that are expected?

APPENDIX I: CHECKLIST TO PREPARE FOR THE SAMARA WORKSHOP:

EVALUATING THE INVESTMENT ENVIRONMENT OF RUSSIAN REGIONS

In order to prepare for discussions at the workshop, please evaluate your oblast in the context of the policy issues that are included on the following charts in response to these questions:

- What are the strengths and weaknesses of the existing policy environment of your oblast as reflected in comments and questions that you have heard from investors or prospective investors?
- What, if anything, has been proposed or accomplished to make specific aspects of the policy environment more favorable to investors?
- How would you rate the policy environment in your oblast or kray with regard to each particular subject area (Use a rating scale of 1 through 5. A rating of 5 would indicate that the environment is extremely positive; 1 would indicate that this is a policy area that discourages investors.)
- Would are some of the actions that could be considered that would make your oblast/kray more attractive to investors in each policy area?
- How important do you think that these changes would be to potential investors? (Use a rating scale of 0 through 5 where 5=very import and 1=not important at all.)

	Current Situation	Strengths	Accomplishments	Weakness	Rating	Actions for Improvement
Credit & Financial Policy Credit Availability Monetary & fiscal policy Taxation Property: Land and capital equipment as collateral Subsidized credit & inputs Accounting standards Inter-oblast policies affecting credit & financial flows						

	Current Situation	Strengths	Accomplishments	Weakness	Rating	Actions for Improvement
Rule of Law & Open Markets Political stability Contract & commercial law/ arbitration & dispute settlement Regulatory/ licensing requirements , enforcement & transparency Open markets linkages at federal-oblast level Land use planning & zoning Market information Intellectual property Migration & labor laws						

APPENDIX II: UTILIZING FOREIGN DIRECT INVESTMENT TO PROMOTE ECONOMIC GROWTH AND DEVELOPMENT

It is a widely accepted that gains in productivity and technological progress are key driving forces behind economic development and stability. This fact has long been recognized in Russia and has been a motivating force for change at the national and local level. Considerable debate has taken place, however, regarding the means by which technological innovation takes place and can be promoted throughout the economy. Historical evidence from across the globe suggests that it is investment in human and physical capital and the creation of an investment climate that is favorable to business that are the most powerful catalysts for promoting innovation and economic growth.

In spite of recent and momentary instability, it is an undeniable fact that the “Asian miracle” of the last several decades can be attributed in large part to government policies that promoted openness to innovation and the transfer of skills, technologies and goods across borders. Countries such as Singapore or the former colony of Hong Kong, which have a small land mass and extremely limited natural resources, have nonetheless undergone phenomenal economic growth by fostering an environment that has utilized the promotion of indigenous and foreign private investment as a means for acquiring capital, technology and market access. In the aftermath of World War II Japanese production was synonymous with inferior, but inexpensively produced goods. By creating an environment that attracted technology-based investment, that country has evolved from one that formerly sought only to imitate the technology of others to one that occupies a position of leadership in technological innovation.

International investors in agriculture, as in other industries, look closely at the overall investment climate of a country prior to making key investment decisions. Among the factors that they consider are general economic indicators; the stability of the government; labor productivity and the pool of skills available in the work force; wages; and infrastructure. Among the most important factors that they consider as well is the supportiveness of national and local government in creating an environment where business can achieve its full potential. Although such factors as the availability of subsidies may sometimes play a role in investor decisions, it is the overall stability of the investment climate that is of the greatest concern to the investor.

The Role of Competition in Promoting Economic Growth

A key factor in recent economic history has also been the role of competition and how it has spurred innovation, technological development and the optimal use of resources. Among the most successful economies, those that have established themselves as economic leaders have done so by successfully implementing policies that establish a competitive for business.

It is true that a nation’s competitive advantage in industry is often geographically concentrated and that the benefits of industrial competitiveness may not be uniformly distributed at the national level. However, it is equally true that nations or regions gain advantage building on their differences and

allowing entrepreneurs to capitalize on perceived advantages that they might enjoy. Competitiveness results from the relationship of a nation or region's individual environment and the sources of competitive advantage in particular industries. These unique conditions are often the result of a confluence of factors, such as natural resources, educational excellence, or demographics such as those as are found in Russia's Black Earth oblasts..

It is nonetheless also important and instructive to consider those instances where economies falter in spite of advantageous endowments in natural and human resources. The critical factor in those cases is most often a policy environment that fails to adequately promote and reward competition or which constrains efforts to constructively build upon natural advantages.

In Russia as elsewhere, the basis for competition is becoming increasingly and intensely local, a fact that is reflected statistically in the uneven economic gains and losses of individual oblasts. The explanation for this phenomenon is found only partially in such factors as natural resource endowments or access to the large markets of nearby population centers. While it is true that geography may enhance certain aspects of competitive advantage, many examples can be found where industries or entire nations have successfully overcome the barriers of market distance or poor resource endowments by creating competitive and attractive investment environments. While the national government surely plays a role in promoting a competitive policy environment, many oblast and local governments are rapidly discovering that their own potential role in creating a growth-oriented and competitive environment is as great or greater than that of Moscow.

The individual circumstances of a particular nation or oblast suggest that there can be no single model for success in economic development strategy. However, there are several factors that have often proved constant in the emergence of economies that have successfully achieved competitive leadership. These include:

- the establishment of a collaborative relationship between government and business;
- the establishment of commonly-held long-term economic objectives;
- the establishment of action agendas to attain commonly-held policy objectives.

The Relationship of Government Institutions with Private Business

There can be little disagreement that a principal role of government, whether at the national or local level, is to ensure the provision of an legal environment that responds to the economic needs and aspirations of its citizens. There appears to be little disagreement in Russia that the goal of economic growth is popularly held, however there is widespread disagreement about how that goal can be achieved. The complexities of economic and political transition ensure that views on this issue may often differ in the extreme.

The dividing line in this debate often places the long-term well-being of the population at large at the opposite pole from the role of individual enterprises as catalysts for more widespread economic

growth. The result is the creation of an brittle ideological divide that stifles debate, rather than encouraging constructive dialogue on attainable solutions. Powerful evidence of this persistent tension is found in unilateral decision-making on matters of economic policy, the absence of dialogue prior to the enactment of policy decisions, or efforts by businessmen to evade their legal or fiscal obligations. The end result of this divergence of views is an environment of uncertainty that stifles growth and defeats efforts by both policymakers and individual businessmen to establish and implement long-term strategies to attain commonly held economic objectives.

Recent political developments provide a partial explanation for this complex problem. Recent years have seen the power of governmental authority eroded. The erosion of power can be seen in the decline of personal and institutional prerogatives and benefits, as well as in the declining resources that are available to public-sector authorities. It is the view of many central government and oblast officials that economic liberalization has set loose forces which, at their worst, can be predatory or contemptuous of the legal authority of public officials, as demonstrated in non-compliance with tax laws. At the same time entrepreneurs complain that they live in fear of the arbitrary or discriminating exercise of power by those same public officials and the seemingly illogical complexities of governmental bureaucracy.

It is certain that each of these views has a basis in reality; public officials and private businessmen have no difficulty in raising tangible examples as proof of their concerns. As often as not, however, the examples cited by each focus on extreme and exceptional instances or use isolated circumstances as a basis for prejudicial views.

The relationship of government institutions and business is further complicated wherever foreign investors are involved and many officials themselves adhere to conflicting sentiments in this regard. While they recognize the economic benefits of foreign investment, they place those businesses in a separate class, as though their motives, needs and economic objectives must be somehow different than those of local entrepreneurs. In truth, the sole fundamental distinction between the two is the following: *only the most localized businesses are captive to the environment in which they find themselves*. Russian capital, like foreign capital, is increasingly mobile and investors are, indeed, conscious of the need to maintain the option to withdraw from any environment that appears hostile or constraining to the viability of their operations. In Russia, where a growing number of oblast administrations recognize the need to be competitive in attracting foreign investment, those who disregard this fundamental distinction are likely to have extreme difficulties in occupying a viable position in the mainstream Russian or global economy. In these circumstances, any rigid distinction between foreign and Russian investment is a misleading one.

The interests of oblast government officials and private business converge on one fundamental factor: the desire for a stable, predictable environment. Neither political leaders nor entrepreneurs can achieve their long-term objectives in an environment that is characterized by radical, arbitrary and unpredictable change. Although sudden change often creates opportunity, it usually breeds opportunism that may serve the interests of only a small minority of officials or businessmen. The fact

remains that there is consensus across the political spectrum on the need for economic, political and stability following the wrenching changes that have taken place in Russia during recent years.

A frequent complaint that is heard in discussions with private businessmen throughout Russia is that they have little opportunity to provide input to the policy-making process at the local level. The gap between political institutions and the private sector is often a wide one in which individual businessmen must fend for themselves. Such an environment contributes to a market for corruption and influence-peddling, wherein officials and businessmen alike conspire for personal advantage to the detriment to the overall well-being of the local economy. This situation is exacerbated by the ongoing bifurcation of the Russian economy, in which financially burdened socially-based enterprises compete with better-endowed entrepreneurial enterprises.

The solution to this dilemma is found in the creation of opportunities for structured dialogue among business organizations and government officials. Contrary to the fears of many oblast officials, such a dialogue does not erode the legal authority of officials to carry out their responsibilities for policy-making or administrative enforcement. To the contrary, it may be viewed as an opportunity to build and strengthen a constituency that is supportive of economic strategies and their implementation.

Lessons derived from other nations suggest that there is no single model that need be applied to structuring opportunities for dialogue on policy. In some countries, associations of businessmen exist in many forms: sector or industry-based, geographically-based, or issue-based. It is often the case that the initial impetus for generating dialogue must come from the business community itself, in which individual businesses or entrepreneurs join forces in an effort to identify solutions to problems that they have in common.